

Opinion **The Long View**

## Bond slump stirs vigilante fears

A sense is setting in among investment professionals that we have a serious problem here

**KATIE MARTIN**



Many governments feel they have to spend to shield households and businesses from the effects of higher oil prices — and they are expecting bond investors to help them out © Kevin Dietsch/Getty Images

**Katie Martin**

Published 11 HOURS AGO

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A bond fund manager I met this week did what he does best — he gave a brief presentation laying out the case for buying bonds. The gist was that prices have dropped a lot, they're nice and cheap, and we possibly have a global economic shock coming our way. Bonds love that kind of misery, so buy the dip, buy bonds.

Satisfied with his work, he told me he headed back to his desk only to see that in the short time he was speaking, global government bonds had taken yet another leg lower, kicking benchmark US borrowing costs another 0.1 percentage points higher.

To normies, that does not sound like much. To bond-market specialists, it's a grindingly ugly move, particularly as it is just the latest in a relentless series of declines in debt markets since the war in Iran began almost three months ago.

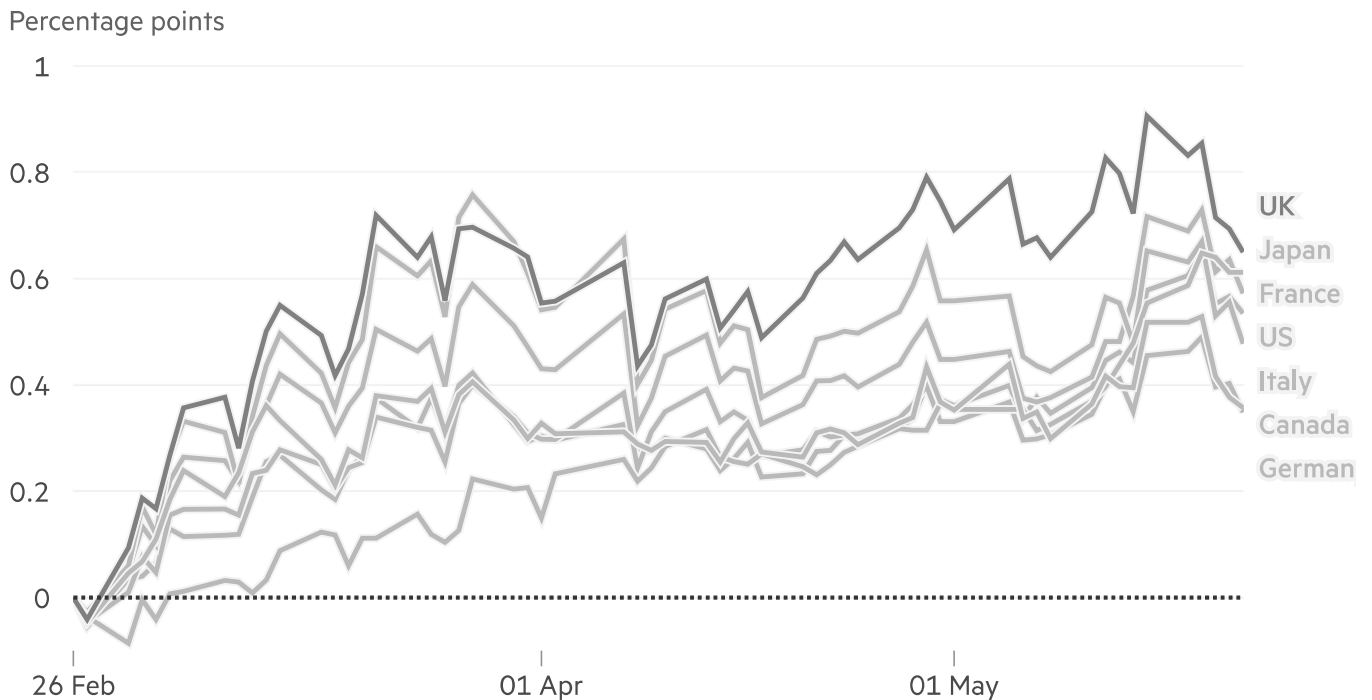
At first, this decline in bond prices, and resulting rise in borrowing costs, looked like a blip, blown out of proportion by the outsized role that fast-moving speculators are now playing in the quirkier corners of the market. But the blip stuck, even when stocks recovered. It then started to look like a global rethink on how higher energy prices might unleash the bond market's mortal enemy — inflation — back on the global financial system.

Now, with energy prices stuck higher, inflation really seems to be taking root again. Central bankers were just starting to believe they had finally done their bit to defeat it and were about to crack open the champagne. Now it's proving sticky once again, and bonds are powerless to avoid its corrosive power.

But the persistent, steady ascent in government borrowing costs is also something more than that. A sense is setting in among bond-market professionals that we have a serious problem here. Finally, the bond vigilantes have arrived.

## What looked like a bond-market 'blip' has become a broad rise in G7 yields

Change in 10-year government bond yields since Iran war began



FINANCIAL TIMES

Source: LSE

Worrywarts have warned for years that this moment would come: that, at some point, investors would simply be saturated with government debt and unwilling to take on any more. Governments in rich economies have been taking on more and more debt since the great financial crisis but got really hooked on the stuff during the Covid-19 pandemic and never looked back. Why bother having honest, difficult conversations with voters about taxes when you can just tap up investors for money?

This is fine until it's not. Now it feels like the Iran crisis is the event that is really crystallising this risk. Higher inflation lays the foundation. But in addition, as a result of this war, politicians have to spend on green energy and more on defence, on top of all the other spending on creaky infrastructure and healthcare.

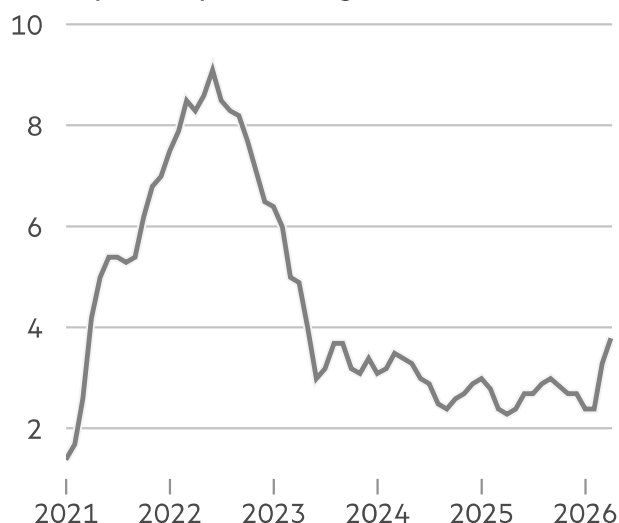
Many governments also feel they have to spend to shield households and businesses from the effects of higher oil prices. They're expecting bond investors to help them out. They will probably get their wish, in a way. Even the UK, with its spicy levels of debt relative to the size of its economy and conspicuously shaky bond market, still manages to draw a crowd when it issues more of the stuff. But the price tag has reset meaningfully higher for governments, leaving them churning more and more money simply into paying the interest. Eventually, we all feel this pain.

## Higher oil prices have put US inflation back in focus

Brent crude (\$ per barrel)



US CPI (year-on-year % change)



FINANCIAL TIMES

Source: LSE

Think of bananas. If I fancy eating one, then sure, I'll buy it if you are selling. I might even pay an extortionate 70p for just one slightly blotchy banana in a popular high-street chain. But if you, for some reason, *need* me to buy dozens of blackened bananas right now, let's just say I'm unlikely to pay 70p a pop. Bond investors are in a similar position, getting a bit fed up with dodgy bananas.

“The most unsettling aspect of a sovereign debt crisis or swoon is that there is not a precise trigger, as it is largely an investor confidence game,” said Greg Peters at PGIM in a note this week.

“Investors never quite know when the trigger is activated, yet we know the preconditions make it quite probable — at some point. Consequently, this latest move is hardly a surprise and fits into the belief that we are in an era where we will experience a rolling series of shocks for the global market.”

As Peters noted, the UK is at the sharp end of this tension, suffering a little more than other comparable economies in its rising borrowing costs as a political circus once again rolls through town. Other governments may find this element of self-inflicted pain drily amusing, but the UK’s hazing may end up as the first of many. “Global politicians should pay attention,” Peters said.

For now, stock markets are unusually resilient to the rise in bond yields. A little stress is visible in stocks outside of the AI magic money machine, but, generally, they are holding up fine, in part because the rise is mostly very steady rather than violent.

There’s still a chance that peace breaks out in Iran, energy supplies immediately get back to normal, inflation subsides, all that extra borrowing doesn’t need to happen after all, and the mythical bond vigilantes will get back in their box. This could genuinely happen, and bond prices do tend to pick up whenever the mood music over Iran brightens. But there’s also a chance that I will win the EuroMillions lottery and if I do, you can be sure that I won’t put it all in bonds. Or bananas.

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